



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Large and Mid-Size
Business Division

MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
DIRECTOR, PFTG, LMSB
DIVISION COUNSEL, LMSB

FROM: Keith M. Jones /s/ Keith M. Jones
Director, Field Specialists LM:FS

SUBJECT: Field Directive on Assertion of the Penalty for
Failure to Deposit Employment Taxes

The purpose of this memorandum is to establish guidelines for examiners on assertion of the penalty for failure to deposit employment taxes owing as a result of exercise of nonqualified stock options. These guidelines are intended to promote the efficiency and consistency of employment tax examinations and to redirect audit resources to other issues. This Field Directive is not an official pronouncement of the law or the Service's position and cannot be used, cited or relied upon as such.

Treas. Reg. § 31.6302-1(c) requires an employer to deposit employment taxes with an authorized financial institution on the next banking day after \$100,000 or more of employment taxes have been accumulated during the deposit period.

I.R.C. Sec. 83(a) provides that if in connection with the performance of services, property is transferred to any person other than the person for whom services were performed, the excess of the fair market value of such property at the first time the rights of the person having a beneficial interest are transferable or are not subject to a substantial risk of forfeiture over the amount paid for such property shall be included in income of the service performer in the first taxable year in which the rights of that person in the property are transferable or are not subject to a substantial risk of forfeiture.

Treas. Reg. § 1.83-7 provides that with regard to a nonqualified stock option without a readily ascertainable fair market value at date of grant, Sec. 83(a) and (b) shall apply at the time the option is exercised or otherwise disposed of.

Treas. Reg. § 1.83-7 further provides that Sec. 83(a) and (b) apply to the transfer of property pursuant to such exercise, and the employee realizes compensation upon such transfer at the time and in the amount determined under Sec. 83(a) and (b).

For purposes of taxes imposed under the Federal Insurance Contributions Act (FICA), Treas. Reg. § 31.3121(a)-2(b) provides that wages are paid by an employer at the time they are actually or constructively paid. Wages are constructively paid when they are credited to the account of or set apart for an employee so that they may be drawn upon by him at any time although not actually reduced to possession. To constitute payment in such a case the wages must be credited or set apart for the employee without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is made, and must be made available to him so that they may be drawn upon at any time, and their payment is brought within an employee's own control and disposition. The regulations related to income tax withholding contain a similar definition. See Treas. Reg. § 31.3402(a)-1(b).

I.R.C. Sec. 3402(a) requires every employer making a payment of wages to deduct and withhold upon such wages. Treas. Reg. § 31.3402(a)-1(b) requires the employer to withhold the amount of the tax at the time the wages are actually or constructively paid. The provisions related to FICA impose a similar obligation on the employer.

Rev. Rul. 67-257, 1967-2 C.B. 359 specifically holds that an employee has the unconditional right to receive stock upon payment of the option price. The excess of the FMV of the stock on the date of exercise over the option price is compensation includible in the employee's income at the time of exercise. An employer's obligation to withhold under I.R.C. Sec. 3402 arises at that time.

Rev. Rul 78-185, 1978-1 C.B. 304 holds that the FMV of stock at the date of crediting it to the employee's account over the cost to him is wages for FICA, FUTA and income tax withholding purposes.

While I.R.C. Sec. 83 and the Regulations thereunder generally point to exercise date as the trigger for inclusion of income from exercise of nonqualified stock options, the FICA and income tax withholding provisions do not impose a withholding obligation on the employer until wages are actually or constructively paid. It has been argued that the shares (or the value of the shares) are not available to the exerciser of the options until settlement date, and therefore no actual or constructive payment of wages takes place until that time.

There is generally only a three day delay between time of exercise and time of settlement resulting from such exercise. In fact, under 17 C.F.R. Sec. 240.15c6-

1(a), the SEC generally established a maximum three day settlement period for broker- dealer trades. There is presently no specific published guidance relative to whether the date of exercise or date of settlement is the appropriate date for considering assertion of the penalty for failure to deposit employment taxes attributable to the exercise of nonqualified stock options. Until such time as guidance is issued or this Field Directive is modified or revoked, LMSB Employment Tax Specialists should not challenge the timeliness of deposits required under Treas. Reg. § 31.6302-1(c), if such deposits are made within one day of the settlement date, as long as such settlement date does not fall more than three days from date of exercise.

If you have any questions or concerns you may contact me at (202)-283-8290, or Pam Christensen, Employment Tax Program Manager, at (775) 824-2234 ext 266.

cc: Commissioner and Deputy Commissioner, LMSB
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